

Report
of the
Examination of
Western Diversified Casualty Insurance Company
New York, New York
As of December 31, 2003

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, Governor
Jorge Gomez, Commissioner

Wisconsin.gov

January 14, 2005

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Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
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Commissioner:

In accordance with your instruction, a compliance examination has been made of the
affairs and financial condition of:

WESTERN DIVERSIFIED CASUALTY INSURANCE COMPANY
New York, New York

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of Western Diversified Casualty Insurance Company (the company) was conducted in 2001 as of December 31, 2000. The current examination covered the intervening period ending December 31, 2003, and included a review of such 2004 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Employees' Welfare and Pension Plans
- Territory and Plan of Operations
- Affiliated Companies
- Growth of Company
- Reinsurance
- Financial Statements
- Accounts and Records
- Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

II. HISTORY AND PLAN OF OPERATION

Western Diversified Casualty Insurance Company (WDCIC or the company) was originally incorporated under the laws of Illinois on August 10, 1987, and began writing contractual liability and mechanical breakdown policies on August 28, 1997. It is the surviving company of a merger between WDCIC and Commercial Mortgage Insurance, Inc. (CMI). CMI was incorporated under the laws of Wisconsin on July 23, 1969, and commenced business on August 19, 1969, writing mortgage guaranty insurance. CMI was acquired by parties affiliated with WDCIC, and effective December 21, 1989, WDCIC was merged into CMI. The name of the surviving entity was then changed back to Western Diversified Casualty Insurance Company and the company was redomiciled from Illinois to Wisconsin. To complete the process, the Wisconsin certificate of authority was amended to remove mortgage guaranty insurance and allow the company to write other property and casualty lines of business. All outstanding liabilities of CMI were transferred to unaffiliated companies prior to the acquisition.

Prior to its acquisition by Arch Insurance Group Inc. (AIGI) in 2003, WDCIC was a wholly owned subsidiary of Western Diversified Services, Inc. (WDS). On September 30, 1997, Protective Life Insurance Company (Protective) acquired the Western Diversified group of companies pursuant to the terms of Stock Purchase Agreement dated July 11, 1997, between John Alden Life Insurance Company, JA Services, Inc., and Protective. WDCIC was acquired indirectly as the subsidiary of a non-insurance entity, WDS, an Illinois corporation, as part of the stock purchase transaction. Protective's ultimate parent is Protective Life Corporation.

Protective Life Corporation entered into an agreement to sell WDCIC to AIGI, a subsidiary of the Arch Capital Group Ltd. (the ultimate parent) domiciled in Bermuda. AIGI purchased the capital stock of WDCIC according to the agreement. The sale was finalized in 2003. WDCIC entered into a service agreement with AIGI and a tax-sharing agreement with Arch Capital Group (U.S.) Inc. as a result of the acquisition.

The change of control to AIGI included the following Stipulation and Order:

1. The company shall not enter into any affiliated reinsurance agreement unless the affiliate has established a reinsurance credit trust on behalf of the company under an agreement approved by this office.

2. The company shall not recognize credit for reinsurance with Arch Reinsurance Ltd., for purposes of computing the company's compulsory and security surplus pursuant to ss. 623.11 and 623.12, Wis. Stat., for any accounting period, unless all of the following conditions are continuously maintained:
 - a. Any reinsurance credit trust established by Arch Reinsurance Ltd. on behalf of the company shall maintain a trust balance in an amount greater than or equal to 104% of the liabilities of Arch Reinsurance Ltd. attributable to the reinsurance treaty or treaties with the company.
 - b. The cash and invested assets in any reinsurance credit trust established by Arch Reinsurance Ltd. on behalf of the company are invested in a manner which complies with ch. 620, Wis. Stat., and s. Ins 6.20, Wis. Adm. Code.
 - c. The shareholders equity of Arch Reinsurance Ltd., as adjusted based on accounting practices and procedures prescribed by the Commissioner for this adjustment, exceeds the security surplus standard of s. 623.12, Wis. Stat., and s. Ins 51.80, Wis. Adm. Code.
 - d. The reserves established by Arch Reinsurance Ltd. are equal in all instances to the reserves ceded to Arch Reinsurance Ltd. reflected on the books and records of the company.
3. The company shall obtain and file the following documents with the Commissioner of Insurance with regard to Arch Reinsurance Ltd.:
 - a. Any amendment or replacement of any trust agreement that establishes a reinsurance credit trust on behalf of the company, not less than 30 days prior to the proposed effective date.
 - b. Annual financial statements prepared in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP) and audited in accordance with the auditing standards generally accepted in the United States of America, by June 1 of each year for the previous calendar year. The company shall prepare an adjustment of the GAAP financial statements based on accounting practices prescribed by the Commissioner for this adjustment. Each report made pursuant to this paragraph is privileged under s. 601.465, Wis. Stat.
 - c. Unaudited GAAP financial statements by March 1 of each calendar year end and within 45 days after each interim calendar quarter. The company shall prepare an adjustment of the GAAP financial statements based on accounting practices and procedures prescribed by the Commissioner for this adjustment. Each report made pursuant to this paragraph is privileged under s. 601.465, Wis. Stat.
 - d. A copy of the trustee's quarterly report of the financial position and activity of any reinsurance credit trust established by Arch Reinsurance Ltd. for the benefit of the company, including an itemized list of assets, by March 1 each calendar year end and within 45 days after end of each interim calendar quarter.
 - e. At the Commissioner's request, provide copies of ceding and retrocession reinsurance agreements to which Arch Reinsurance Ltd. is party.
4. The company's compulsory surplus shall be the greater of:
 - a. 2,000,000; or
 - b. the sum of:
 - (i) An amount equal to fifty percent (50%) of net premiums written for medical malpractice and medical liability insurance in the preceding twelve calendar months; and

- (ii) An amount equal to twenty percent (20%) of net premiums written for all other covered lines of insurance in the preceding twelve calendar months.
- 5. The company shall maintain surplus in excess of its security surplus standard pursuant to s. 623.12, Wis. Stat., and s. Ins. 51.80 (4), Wis. Adm. Code.
- 6. The company shall maintain a ratio of total adjusted capital to authorized control level risk-based capital of not less than 275%.
- 7. The company shall maintain a ratio of gross premiums written to surplus of less than 900%.
- 8. The company shall not waive any run off provision pursuant to the terms of any reinsurance agreement with an affiliate without prior written consent of the Commissioner.
- 9. The company will be deemed a new insurer from the date it is acquired by Arch Capital Group, Ltd., for the purposes of the application of ss. 611.28 and 617.22, Wis. Stat.
- 10. The company shall retain an appointed actuary to opine upon the gross and net reserves reported in its statutory annual statement, and this appointed actuary shall send a copy of his complete actuarial report in support of his opinion to the Commissioner by each April 1st for the preceding calendar year.
- 11. The company will file each contract with any nonaffiliated investment manager and each securities safekeeping agreement with any bank with the Commissioner for the first twelve months following its acquisition by Arch Capital Group, Ltd.
- 12. For purposes of this Stipulation and Order, the application of the Wisconsin Statutes and the Wisconsin Administrative Code are not modified except as explicitly stated in the order.
- 13. The company agrees that this Stipulation and Order is made without reservation and constitutes a waiver of valuable rights including a hearing, confrontation and cross-examination of witnesses, production of evidence, making a motion for costs, and judicial review. The Commissioner may enforce this Stipulation and Order. In addition, if the company is involved in a future administrative or disciplinary action, this Stipulation may be considered.

In 2003, the company did not write direct premium. The company is licensed in the District of Columbia and all states except Connecticut, New Jersey, New York, and Vermont.

The following table is a summary of the net insurance premiums written by the company in 2003. The growth of the company is discussed in the "Financial Data" section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Inland marine	\$ (84)	\$	\$ 84	\$0
Other liability - occurrence	(7,486)		7,486	0
Auto physical damage	(7,209)		7,209	0
Write-ins for other lines of business:				
Extended Service	(602,629)	(23,930)	626,559	0
GAP Addendum	(253,320)		253,320	0
Financial Reserve	<u>2,172</u>	<u> </u>	<u>(2,172)</u>	<u>0</u>
Total All Lines	<u><u>\$ (868,556)</u></u>	<u><u>\$ (23,930)</u></u>	<u><u>\$ 892,486</u></u>	<u><u>\$0</u></u>

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of six members. These directors are elected annually to serve a one-year term. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. The board members currently receive no compensation other than their normal salaries for serving on the board.

Currently the board of directors consists of the following persons:

Name and Residence	Principal Occupation	Term Expires
Ralph E. Jones III West Simsbury, Connecticut	President and CEO, Arch Insurance Group Inc.	2005
Mark D. Lyons Deer Park, Illinois	Executive Vice President, Ins. Group Operations & Chief Actuary Arch Insurance Group Inc.	2005
Martin J. Nilsen Rockville Centre, New York	Senior Vice President, Secretary and General Counsel Arch Insurance Group Inc.	2005
Thomas G. Kaiser Highlands, New Jersey	Executive Vice Pres. & President Marine, Property, Energy & Aviation Division Arch Insurance Group Inc.	2005
Fred S. Eichler New York, New York	Senior Vice President, Chief Financial Officer Arch Insurance Group Inc.	2005
Ellen H. Darrigrand Dunwoody, Georgia	Executive Vice President & CAO Arch Insurance Group Inc.	2005

Officers of the Company

The officers serving at the time of this examination are as follows:

Name	Office	2003 Compensation
Ralph E. Jones III	President and CEO	\$ 816,995*
Thomas G. Kaiser	President, Property, Energy and Marine Division	1,308,501
Mark Lyons	Executive Vice President, Ins. Group Operations & Chief Actuary	876,494
Fred S. Eichler	Senior Vice President, Chief Financial Officer	239,057*
Martin J. Nilsen	Senior Vice President, Secretary & General Counsel	300,892
Ramin Taraz	Vice President & Controller	254,574

* The amount reflects the estimated annual compensation rather than the actual, which is not a full year's compensation. Amount shown includes bonuses when applicable; Arch Group requires an officer to work a full calendar year to be eligible for a bonus, so some amounts do not include bonuses.

Amounts reported are total compensation paid by Arch Insurance Group Inc. and are allocated to affiliates. Western was charged a flat fee as the company was acquired in 2003.

Committees of the Board

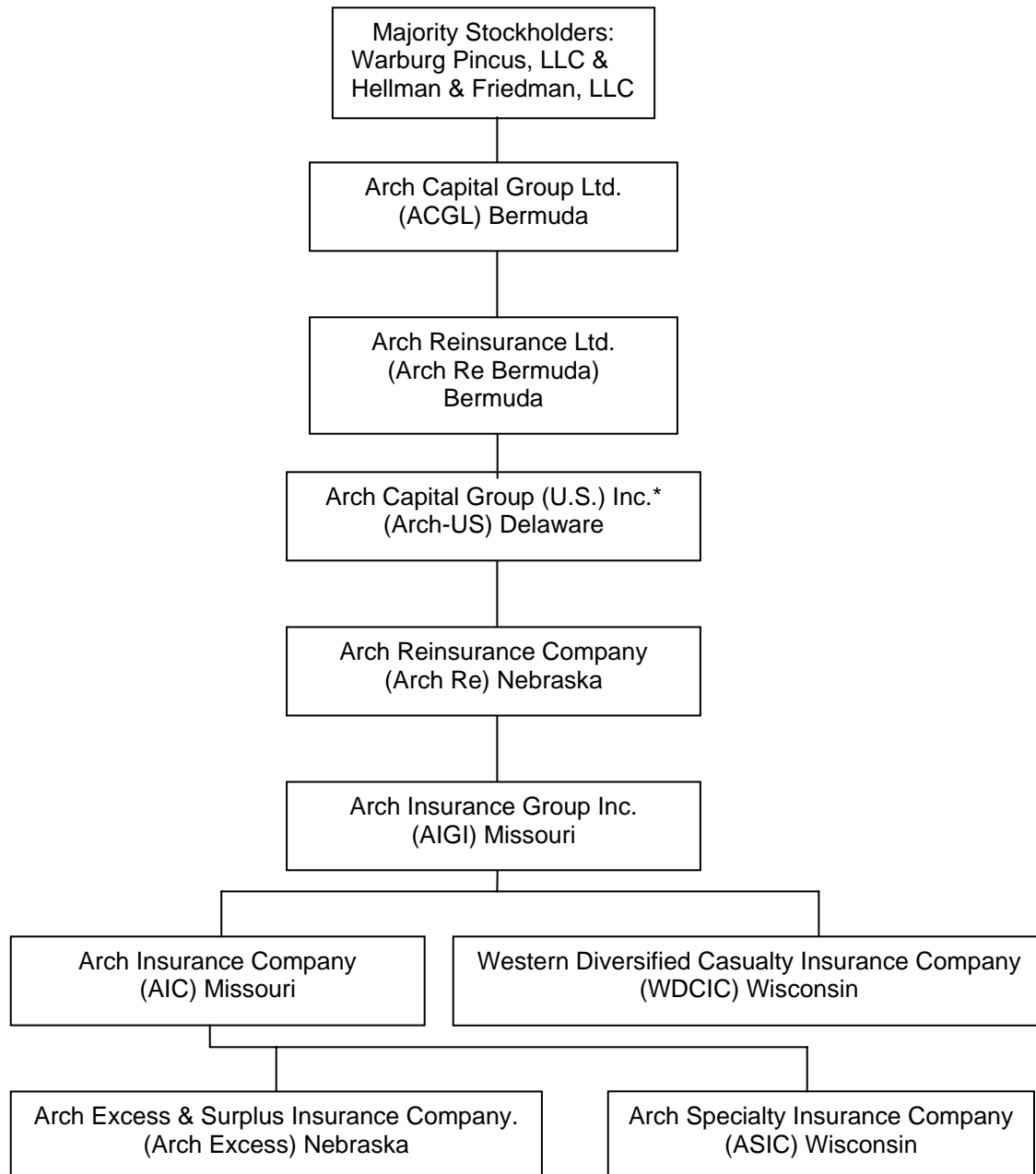
The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

Executive Committee
Ralph E. Jones III, Chair
Mark D. Lyons
Fred S. Eichler
Martin J. Nilsen

IV. AFFILIATED COMPANIES

Western Diversified Casualty Insurance Company is a member of a holding company system ultimately owned by Arch Capital Group Ltd., a Bermuda public limited liability company (hereinafter the Arch holding company system). Investment funds associated with Warburg Pincus LLC and Hellman & Friedman LLC own a majority of ACGL outstanding shares, and are also deemed to be controlling parties. Due to the size and complexity of the corporate interests of the Arch Capital Group, this report will confine its discussion to affiliated companies that have a direct relationship through shared services or other agreements with Western Diversified Casualty Insurance Company. The organizational chart, on the next page, depicts the applicable portion of the holding company system defined above. A brief description of the significant affiliates follows the organizational chart.

**Organizational Chart
As of December 31, 2003**



*Arch-US is owned 86.6% by Arch Re Ltd. and 13.4% owned by Alternative Re Ltd. another affiliate.

Majority Stockholders

Investment funds affiliated with Warburg Pincus LLC and Hellman & Friedman LLC together own a majority of ACGL's outstanding voting shares and have the right to have directors on ACGL's board and to approve most transactions outside of the ordinary course of business.

Arch Capital Group Ltd.

Arch Capital Group Ltd. (ACGL) (a Bermuda company) is the ultimate parent of the group and is a holding company with majority stockholders, Warburg Pincus LLC and Hellman & Friedman LLC. As of December 31, 2003, the audited financial statements of ACGL reported assets of \$5.585 billion, liabilities of \$3.874 billion, and stockholders equity of \$1.710 billion. Operations for 2003 produced net income of \$281 million.

Arch Reinsurance Ltd.

Arch Reinsurance Ltd. (Arch Re Bermuda) (a Bermuda company) provides insurance and reinsurance on a worldwide basis. Insurance written includes professional liability, casualty, and property coverage. Arch Re Bermuda is a wholly owned subsidiary of ACGL. As of December 31, 2003, the audited non-consolidated GAAP financial statements of Arch Re Bermuda reported assets of \$4.268 billion, liabilities of \$2.461 billion, and stockholders equity of \$1.807 billion. Operations for 2003 produced net income of \$297 million.

Arch Capital Group (U.S.) Inc.

Arch Capital Group (U.S.) Inc. (Arch-US) is a holding company domiciled in Delaware. It wholly owns Arch Reinsurance Company, a Nebraska-domiciled reinsurance company. As of December 31, 2003, Arch-US reported unaudited consolidated GAAP assets of \$3.310 billion, liabilities of \$2.829 billion, and stockholders equity of \$481 million. Operations produced net income of \$32 million.

Arch Reinsurance Company

Arch Reinsurance Company (Arch Re) is a Nebraska reinsurer wholly owned by Arch-US. It is a licensed reinsurer in 45 states and the District of Columbia and is accredited in the remaining five states. Arch Re writes significant portions on a select number of specialty property and casualty reinsurance treaties and cedes 90% to Arch Re Bermuda. As of December 31,

2003, Arch Re reported statutory net admitted assets of \$718 million, liabilities of \$335 million, and surplus of \$383 million. Operations produced a net income of \$29 million.

Arch Insurance Group Inc.

Arch Insurance Group Inc. (AIGI) is wholly owned by Arch Re and is a Missouri-domiciled holding company. AIGI wholly owns insurance and service companies, including the company and Arch Insurance Company (Missouri). The latter is the parent of Arch Specialty Insurance Company (Wisconsin). See the “Subsequent Events” section on a subsequent change of control of the company. AIGI reported unaudited consolidated GAAP assets of \$2.171 billion, liabilities of \$1.870 billion, and stockholders equity of \$301 million. Operations produced a net profit of \$4.6 million.

Arch Insurance Company

Arch Insurance Company (AIC) is a Missouri-domiciled insurance company. AIC is licensed in all 50 states and the District of Columbia and Puerto Rico. AIC is wholly owned by AIGI. AIC writes property and casualty business, with a significant portion of the business being written in California and New York. AIC owns two insurance companies: Arch Specialty Insurance Company and Arch Excess & Surplus Insurance Company. As of December 31, 2003, AIC reported statutory audited net assets of \$651 million, liabilities of \$402 million, and surplus of \$249 million. Operations produced a net loss of \$1.4 million.

Arch Excess & Surplus Insurance Company

Arch Excess & Surplus Company (Arch Excess) is a Nebraska-domiciled insurance company approved as a surplus lines company in 41 states and the District of Columbia. The company is wholly owned by AIC. The company writes the following specialty lines: fire (including general property, excess and surplus and technical risk), allied (including general property, excess and surplus and technical risk), medical malpractice (including health care programs and facilities), and other liability insurance (including excess casualty, primary casualty and construction casualty). As of December 31, 2003, Arch Excess reported audited statutory net admitted assets of \$28 million, liabilities of \$5 million, and surplus of \$23 million. Operations produced a net income of \$1.3 million.

Arch Specialty Insurance Company

Arch Specialty Insurance Company (Arch Specialty) is a Wisconsin-domestic insurance company wholly owned by AIC. Arch Specialty is only licensed in Wisconsin and is a surplus and excess lines writer approved in 48 states and the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The company writes specialty lines of business through six profit centers as further described below.

The Casualty profit center is comprised of two subdivisions: Primary and Excess. Primary Casualty writes general liability and products liability coverage for a variety of classes. The main concentration is on commercial and residential contracting, commercial and residential premises risks, and manufacturing/products risks. Excess Casualty writes both lead umbrellas and excess umbrellas up to \$25 million in capacity. The principal areas of focus are commercial contracting, manufacturing, small municipalities, service industries, and both commercial and residential premises risks. Casualty is marketed primarily through wholesale brokers.

Property consists of global risks with up to \$50 million in capacity. Property risks are written through both retail and wholesale brokers.

Executive Assurance writes commercial accounts (concentrating on Fortune 2000 companies), emerging markets (non-tech public companies with less than \$350 million in revenues, private companies, nonprofit companies and public technology and biotechnology companies with less than \$1 billion in market capital) and financial institutions (e.g., banking, insurance, and registered money management industries). Executive Assurance is marketed through both retail and wholesale broker relationships.

Health care includes large health care accounts, consisting primarily of hospitals and health systems, miscellaneous facilities, which is a diverse classification of risks providing outpatient health care services, and at least one health care program. Large health care is written mainly through retail brokers and miscellaneous facilities business is written mainly through wholesale brokers.

Professional liability includes coverage for large law firms and large accounting firms, miscellaneous professional liability [consisting of coverage for middle market and larger “near” or

quasi-professions (e.g., large real estate and insurance brokerage firms, but excluding the traditional professions, such as lawyers, accountants, architects, engineers, and health care professionals)], captive agents professional liability for P&C and life agents of insurance companies with large, captive or semi-exclusive agency forces, brokers-dealers associated with life insurance companies, and design liability which focuses on professional liability for architects, engineers, and construction managers. Professional liability is also comprised of environmental liability, which focuses on fixed-site pollution coverage, professional liability for environmental professionals and contractor's pollution liability. Large law and accounting firms and programs are written through an open brokerage basis. Miscellaneous professional liability and captive agents are written through an open brokerage basis. Design, environmental and accident and health liability are written primarily under programs through large producers (Managing General Underwriters or MGU's).

Construction and surety business includes excess and umbrella coverage for large accounts. Business is developed through a limited number of retail and wholesale brokers. Arch Specialty was examined at the same time as the company and is the subject of a separate report. As of December 31, 2003, Arch Specialty reported audited statutory net admitted assets of \$321 million, liabilities of \$210 million, and surplus of \$111 million. Operations produced a net income of \$1.3 million.

Agreements with Affiliates

Tax-Sharing Agreement

The company participates in a Tax-Sharing Agreement with its parent, Arch-US, and other affiliated companies. Arch-US assumes responsibility for preparing the tax returns and is reimbursed by its subsidiaries, including the company. Tax is computed as if each subsidiary is on a stand-alone basis. Payments are due before the end of the calendar month in which the parent paid the tax.

Equipment Cost Allocation Agreement

This is an agreement to spread the depreciation cost of equipment owned by AIC. The depreciation is allocated by the direct premiums written by each subsidiary to the total direct

premium written by all subsidiaries. This agreement was effective June 1, 2004. Payment is due within 30 days after each quarterly billing.

Administrative Service Agreement

This agreement calls for AIGI to provide accounting, data processing, systems work, records, information technology, legal services, and other administrative services (office space, advertising, etc.) for the efficient operation of the company. The expenses incurred by AIGI on behalf of the company are billed at any time throughout the month or at least quarterly with payment due within 10 days of billing.

V. REINSURANCE

The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contracts contained proper insolvency provisions.

The company is currently not writing any new business. The company's reinsurance contract with its affiliate Arch Re Bermuda is outlined herein. The company intends to start writing business in 2005.

The business written prior to Arch Capital Group Ltd.'s acquisition of the company is reinsured and guaranteed by Lyndon Property Insurance Company under a 100% coinsurance agreement, which is supported by a guarantee agreement by Protective Life Corporation and Lyndon Insurance Group, Inc.

Affiliated Ceding Contracts

1. Type: 90% Quota Share Reinsurance
- Reinsurer: Arch Reinsurance Ltd. (Bermuda Affiliate)
- Trust agreement: Reinsurer is to enter into a trust agreement for the benefit of the company in an amount equal to 104% of the reinsurer's obligation to the company, pursuant to the Stipulation and Order discussed earlier in this report. As of February 9, 2005, the trust agreement had not been executed by the company; management stated that as soon as business began it would make the necessary deposit into the related trust account, since it was not cost effective to set up the trust prior to writing business.
- Scope: All business written except business produced by the reinsured's alternative market business profit centers or its lenders' products policies or programs, and, in the case of the reinsured's program business profit centers, programs that first incept or renew during the term hereof.
- Effective date: January 1, 2004
- Termination: By either party with 365 days prior written notice. In addition, special provisions exist in the event of either party becoming insolvent or otherwise financially impaired.
- Retention: 10% of its net retained liability
- Coverage: 90% of its net retained liability with stated exclusions
- Premium: 90% of the net written premium

Commissions: 28.5% of the net written premium adjusted annually, on a retroactive basis, by a transfer pricing analysis

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2003, annual statement. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Western Diversified Casualty Insurance Company
Assets
As of December 31, 2003

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	\$ 5,636,133	\$	\$ 5,636,133
Cash	4,044,523		4,044,523
Short-term investments	252,480		252,480
Investment income due and accrued	46,831		46,831
Current federal and foreign income tax recoverable and interest thereon	74,264		74,264
Receivable from parent, subsidiaries, and affiliates	24,172		24,172
Other assets nonadmitted	12,550	12,550	
Write-ins for other than invested assets:			
Taxes, licenses, and fees recoverable	<u>33,506</u>	<u> </u>	<u>33,506</u>
Total Assets	<u>\$10,124,459</u>	<u>\$12,550</u>	<u>\$10,111,909</u>

Western Diversified Casualty Insurance Company
Liabilities, Surplus, and Other Funds
As of December 31, 2003

Payable to parent, subsidiaries, and affiliates		\$	4,750
Write-ins for liabilities:			
Other liability			<u>14,174</u>
Total Liabilities			18,924
Common capital stock	\$5,000,000		
Gross paid in and contributed surplus	5,011,328		
Unassigned funds (surplus)	<u>81,657</u>		
Surplus as Regards Policyholders			<u>10,092,985</u>
Total Liabilities and Surplus			<u>\$10,111,909</u>

Western Diversified Casualty Insurance Company
Summary of Operations
For the Year 2003

Underwriting Income

Premiums earned		\$ 0
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Deductions:

Other underwriting expenses incurred	\$ 81,053	
Total underwriting deductions		<u>81,053</u>
Net underwriting (loss)		(81,053)

Investment Income

Net investment income earned	254,733	
Net realized capital (losses)	<u>(9)</u>	
Net investment gain		<u>254,724</u>

Net income before dividends to policyholders and before federal and foreign income taxes		173,671
Federal and foreign income taxes incurred		<u>(77,538)</u>

Net Income		<u>\$251,209</u>
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Western Diversified Casualty Insurance Company
Cash Flow
For the Year 2003

Net investment income			\$ <u>253,817</u>
Total			253,817
Benefit- and loss-related payments	\$(2,864,422)		
Commissions, expenses paid, and aggregate write-ins for deductions	12,089		
Federal and foreign income taxes paid (recovered)	<u>(3,274)</u>		
Total deductions			<u>(2,855,607)</u>
Net cash from operations			3,109,424
Proceeds from investments sold, matured, or repaid:			
Net gains (losses) on cash and short- term investments	\$ 39,796		
Miscellaneous proceeds	<u>12,387</u>		
Total investment proceeds		52,183	
Cost of investments acquired (long-term only):			
Bonds	5,091,477		
Miscellaneous applications	<u>40,927</u>		
Total investments acquired		<u>5,132,404</u>	
Net cash from investments			(5,080,221)
Cash from financing and miscellaneous sources:			
Dividends to stockholders	15,464,600		
Other cash provided (applied)	<u>(2,732,741)</u>		
Net cash from financing and miscellaneous sources			<u>(18,197,341)</u>
Reconciliation			
Net change in cash and short-term investments			(20,168,138)
Cash and short-term investments, December 31, 2002			<u>24,465,142</u>
Cash and short-term investments, December 31, 2003			<u>\$ 4,297,004</u>

Western Diversified Casualty Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2003

Assets		\$10,111,909
Less liabilities		<u>18,924</u>
Adjusted surplus		10,092,985
Annual premium:		
Lines other than accident and health	\$0	
Factor	<u>20%</u>	
Compulsory surplus (subject to a minimum of \$2 million)		<u>2,000,000</u>
Compulsory surplus excess (or deficit)		<u>\$ 8,092,985</u>
Adjusted surplus (from above)		\$10,092,985
Security surplus: (140% of compulsory surplus, factor reduced 1% for each \$33 million in premium written in excess of \$10 million, with a minimum factor of 110%)		<u>2,800,000</u>
Security surplus excess (or deficit)		<u>\$ 7,292,985</u>

Western Diversified Casualty Insurance Company
Reconciliation and Analysis of Surplus
For the Three-Year Period Ending December 31, 2003

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	2003	2002	2001
Surplus, beginning of year	\$25,318,926	\$39,800,368	\$39,156,353
Net income	251,209	1,622,974	(125,655)
Net unrealized capital gains or (losses)		385,071	769,670
Change in net deferred income tax		(285,199)	227,016
Change in non-admitted assets	(12,550)	285,199	(285,199)
Cumulative effect of changes in accounting principles			58,183
Capital changes:			
Transferred from surplus	(32,988,672)		
Surplus adjustments:			
Paid in		3,500,000	
Transferred to capital	32,988,672		
Dividends to stockholders	<u>(15,464,600)</u>	<u>(19,989,487)</u>	<u> </u>
Surplus, end of year	<u>\$10,092,985</u>	<u>\$25,318,926</u>	<u>\$39,800,368</u>

**Western Diversified Casualty Insurance Company
Insurance Regulatory Information System
For the Three-Year Period Ending December 31, 2003**

The company's NAIC Insurance Regulatory Information System (IRIS) results for the period under examination are summarized below. Unusual IRIS results are denoted with asterisks and discussed below the table.

	Ratio	2003	2002	2001
#1	Gross Premium to Surplus	0.0%	11.0%	41.0%
#2	Net Premium to Surplus	0.0	0.0	0.0
#3	Change in Net Writings	0.0	0.0	0.0
#4	Surplus Aid to Surplus	0.0	0.0	0.0
#5	Two-Year Overall Operating Ratio	0.0	0.0	999.0*
#6	Investment Yield	1.5*	5.3	5.4
#7	Change in Surplus	(60.0)*	(36.0)*	2.0
#8	Liabilities to Liquid Assets	0.0	19.0	2.0
#9	Agents' Balances to Surplus	0.0	0.0	0.0
#10	One-Year Reserve Development to Surplus	0.0	0.0	0.0
#11	Two-Year Reserve Development to Surplus	0.0	0.0	1.0
#12	Estimated Current Reserve Deficiency to Surplus	0.0	0.0	0.0

The company was acquired in 2003 by ACGL. This report will comment on only those exceptional ratios since being acquired. Ratio number 6 calculates the investment yield of the company. The amount is exceptional due to low yields in bond investments. Ratio number 7 calculates the percentage Change in Surplus. The 2003 exceptional value is due to a dividend paid to the previous parent prior to the change of ownership.

Growth of Western Diversified Casualty Insurance Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
2003	\$10,111,909	\$ 18,924	\$10,092,985	\$ 251,209
2002	30,019,056	4,700,130	25,318,926	1,622,974
2001	40,463,828	663,460	39,800,368	(125,655)
2000	40,819,107	1,662,754	39,156,353	1,444,849

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
2003	\$ (892,486)	\$ 0	\$ 0	0.0%	0.0%	0.0%
2002	2,741,904	0	0	0.0	0.0	0.0
2001	16,408,310	0	0	0.0	0.0	0.0
2000	72,039,716	(30,964,898)	45,311,536	104.0	(15.5)	88.5

There were no trends of note since the company was acquired in 2003 by Arch Capital Group Ltd. Gross premiums written in the earlier years include contract liability and mechanical breakdown insurance, which was reinsured to the company's former affiliates.

Reconciliation of Surplus per Examination

No adjustments were made to surplus as a result of the examination. The amount of surplus reported by the company as of December 31, 2003, is accepted.

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were nine specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Management and Control—It is recommended that the company report to this office regarding the business purpose of the indemnification agreement and any contingent liability within 15 days of adoption of this report and, if no legitimate business can be identified, take immediate action to void the consent and any related agreements.

Action—Not applicable, new owners and no indemnification agreement noted.

2. Holding Company—It is recommended that the company disclose guarantees issued or received by Western Diversified Casualty Insurance Company on Form B of the holding company registration statement.

Action—Not applicable, no guarantees issued with new owner of company.

3. Accounts and Records—It is recommended that the company book transactions on a timely basis in accordance with accounting principles

Action—Compliance.

4. Accounts and Records—It is recommended that the company comply with s. Ins 6.80 (4), Wis. Adm. Code, regarding the retention of records.

Action—Compliance.

5. Accounts and Records—It is recommended that the company report only assets held in its name on the annual statement pursuant to s. 610.23, Wis. Stat.

Action—Compliance.

6. Accounts and Records—It is recommended that the company draft formalized agreements for any administrative services being performed for affiliated companies and submit such agreements to the commissioner in compliance with s. Ins 40.04, Wis. Adm. Code.

Action—Compliance.

7. Biographical Sketches—It is recommended that the company file biographical sketches within 15 days of the election or appointment of any new director, trustee, or officer as required by s. Ins 6.52, Wis. Adm. Code.

Action—Compliance.

8. Executive Compensation—It is recommended that the company provide information as requested during the examination pursuant to s. 601.42, Wis. Stat.

Action—Compliance.

9. Invested Assets—It is recommended that the company amend its corporate custodian agreement to obligate the custodian to promptly indemnify the company for losses caused by negligence or dishonesty of the custodian and the custodian's chosen depositories and sub custodians, and to maintain the company's securities in such a manner that at all times they may be identified as belonging solely to the company.

Action—Noncompliance, additional comment on this area can be found in the following section.

Summary of Current Examination Results

Custodial Agreement

The majority of the company's securities are held by a bank under a safekeeping agreement. The agreement did not contain satisfactory safeguards and controls as specified in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. This was a recommendation under the previous ownership which related to the custodial agreement in place at the time. Arch management had attempted to correct its language after another state's examination of an affiliate. It is again recommended that the company amend its safekeeping agreement to include provisions requiring:

- That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and
- That, in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

Business Continuity/Disaster Recovery Plans

During the review of the information systems it was noted by the examiner that the company had not completed business continuity or disaster recovery plans for key insurance locations and financially significant insurance operations. During 2004, the company hired a consulting service to assist in establishing a centralized, coordinated company-wide business continuity and disaster recovery plan for all key insurance group locations. The company projects that the plans will be completed by the end of 2004 and expects testing to be conducted shortly thereafter. It is recommended that the company complete its business continuity/disaster recovery plans for key insurance locations and financially significant insurance operations and once completed the plans should be reviewed, updated, and tested on an annual basis.

VIII. CONCLUSION

The company was acquired in 2003 by the Arch Capital Group Ltd. The company has not written any new business since the acquisition. Premiums written in the earlier years include contract liability and mechanical breakdown insurance, which was reinsured to the company's former affiliates. Prior recommendations were reviewed for compliance; two were determined to no longer apply since the company is no longer owned by the prior parent. The company complied with all others with the exception of the custodial agreement language which was repeated. There was one other new recommendation regarding the business continuity/disaster recovery plan of the company. A summary of the recommendations follow this section of the report.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 30 - Custodial Agreement—It is again recommended that the company amend its safekeeping agreement to include provisions requiring:
 - That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and
 - That, in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.
2. Page 30 - Business Continuity/Disaster Recovery Plans—It is recommended that the company complete its business continuity/disaster recovery plans for key insurance locations and financially significant insurance operations and once completed the plans should be reviewed, updated, and tested on an annual basis.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Tim Vande Hey	Advanced Examiner/IT Specialist
Sheur Yang	Financial Examiner
William C. Genne	Financial Examiner

Respectfully submitted,

David A. Grinnell
Examiner-in-Charge

XI SUBSEQUENT EVENTS

PSA Agreements

The New York Attorney General started an investigation and has prosecuted some cases regarding placement service agreements between brokers and insurance companies. The charges to date are for alleged bid rigging and client steering. The company was not mentioned in the Attorney General's suit, but the company's affiliates did have placement service agreements with brokers. The group suspended payments under existing agreements and has no plans to enter into any new placement service agreements with any brokers or agents. The company's ultimate parent announced in its September 2004 form 10Q that it was not presently aware of any employees having engaged in bid rigging and it had hired an outside legal firm to conduct an internal review with respect to these issues as a proactive measure.

Hurricanes and Typhoon

Arch Capital Group Ltd. (Bermuda) announced on October 6, 2004, that, based upon current estimates, it expects net losses, on an after tax basis, resulting from Hurricanes Charley, Frances, Ivan, and Jeanne and Typhoon Songda to reduce 2004 third quarter net income by approximately \$140 million.

Lawyer Professional Malpractice Coverages

Arch Capital Group Ltd. (Bermuda) announced in a December 3, 2004, press release that it received a subpoena from the New York Attorney General requesting certain information regarding its underwriting activities with respect to insurance coverages provided to lawyers and law firms for acts of professional malpractice. Arch Capital Group Ltd. noted it intended on cooperating with this request.

Change in Control

The company's stock was contributed from AIGI to Arch Insurance Company effective December 31, 2004. This transaction was reported to this office and was approved in February 2005 and was also approved by the Missouri Insurance Department.

Stipulation and Order

The company informed this office in 2005 that it was in the process of beginning to write business throughout the company. They had not planned on establishing a trust agreement. This would be in violation of the Stipulation and Order. This office is in correspondence with the company about this issue.